Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NEW:LM:DET:TL-N-3612-00
RSBloink

date: OCT 13 2000

to: Territory Manager, (Retailers, Food & Pharmaceuticals)
Attn: Team Manager Dave Horton

from: Associate Area Counsel, LMSB Division, Detroit

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subject: [redacted]
Employee Bonuses

This memorandum responds to your request for assistance regarding the payment of $[redacted] of employee bonuses to key employees pursuant to the [redacted] sale of [redacted] by its principal shareholder. This issue is being coordinated with George Johnson of our National Office. The advice in this memorandum is subject to ten day post-review in the National Office, pursuant to CCDM (34)3(19)4, and should not be relied upon for a period of thirty days. If you have any questions, please call the undersigned at (313)237-6433.

DISCLOSURE STATEMENT

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This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

ISSUE

Whether $[redacted] of employee bonuses paid pursuant to the principal shareholder's sale of [redacted]% of his [redacted] stock should be capitalized to the basis of the seller's stock.

CONCLUSION

NO. The $[redacted] is properly treated as a liability of the acquired corporation to be capitalized within the buyer's purchase price as an assumed liability.

FACTS

Prior to [redacted], [redacted] was a privately held S-corporation, which owned as a wholly-owned subsidiary, [redacted] the [redacted] company. [redacted] and [redacted] and related trusts, were the sole shareholders of [redacted] In [redacted] the decision was made to sell [redacted] to the [redacted] a [redacted] Massachusetts investment company. In furtherance of the proposed sale, the parties executed the attached Agreement and Plan of Merger on [redacted] The merged corporation was a C corporation taking the name of [redacted] The plan of merger called for the successor corporation to then immediately undergo a recapitalization. Pursuant to this recapitalization, the [redacted] and related parties were issued shares representing [redacted]% of the successor [redacted] stock. [redacted] and [redacted] the founders of [redacted] retained only a [redacted]% equity interest in the surviving corporation. The effective date of this merger of [redacted] was [redacted]

Article 6.12(b) of the Agreement and Plan of Merger provides:

> At the Effective time, the Principal Stockholder, on behalf of the Stockholders, shall authorize and direct the Buyer to pay or cause to be paid the **Company Transaction Expenses**, less any required withholding Taxes, out of the aggregate Merger Consideration. After the Effective Time, the Surviving Corporation may, at its option, elect to have any **Company Transaction Expenses** that are not paid out of the aggregate Merger Consideration at the Effective Time be paid by the Principal Stockholder or paid out of the Escrow Account; *provided* that all Tax withholding and reporting requirements shall be satisfied.

The term "**Company Transaction Expenses**" is defined within Article 1 of the Agreement to include, "any and all stay pay, completion bonus, success bonus, severance or other compensation obligations that are contingent upon, or may be or become payable as a result of , the consummation of the transactions contemplated by the Agreement that are incurred or assumed by [redacted]. . ."

On the effective date of the merger, and in accordance with Article 6.12 of the Agreement, the principal stockholder, [redacted], directed the purchaser to pay several key employees bonuses totaling $[redacted]. These bonuses were in addition to the buyouts made of the deferred compensation plans of these very same executives, in accordance with Severance Agreements executed [redacted]. These additional bonuses were paid in recognition of the employees merger related transactional activities. The $[redacted] was paid subsequent to the effective date of the merger but prior to the end of the [redacted] taxable year. Forms W-2s were properly issued for these payments by a subsidiary of [redacted] to the effected employees. The [redacted] elected under Article 6.12 to have this $[redacted] bonus paid out of the merger consideration. Thus, $[redacted] of the agreed net purchase price was used to pay these bonuses.

But for the decision to pay this additional bonus, the [redacted] would have received $[redacted] in redemption of their shares after providing for payment of professional fees and an escrow, as opposed to the $[redacted] actually received. As such, this transaction could be re-construed in substance as the [redacted] receiving an additional $[redacted] in consideration, and then choosing to contribute it to the capital of [redacted] for the specific purpose of making these bonus payments. Such a contribution would presumably increase the [redacted]'s basis in their remaining [redacted] shares. In the alternative, the [redacted]'s chose to treat this as a reduction in the amount realized upon the sale of a [redacted]% stake in [redacted]. In effect, the [redacted]'s treated the obligation to make these bonus payments as a fixed liability assumed by the buyer as part of the consideration offered for their [redacted] shares.

LAW

Courts have consistently held costs incurred in connection with a corporate acquisition should be capitalized by the acquiring corporation. See, INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992) (legal and investment banking fees); Bilar Tool & Die v. Commissioner, 530 F.2d 708 (6th Cir. 1976) (legal and accounting fees incurred in connection with a reorganization); Vulcan Materials Co. v. United States, 446 F.2d 690 (5th Cir. 1971), cert. denied, 404 U.S. 942 (1971) (recapitalization expenses). In determining whether a liability was incurred incident to a corporate reorganization or recapitalization the courts consider the origin of the claim. See, United States v. Gilmore, 372 U.S. 39 (1963).

Liabilities are incurred in connection with a reorganization when the services giving rise to these liabilities are in furtherance of and directly connected with the corporate reorganization. See, Rev. Rul. 73-580, 1973-2 C.B. 86 (Salaries paid in connection with internal legal, accounting, and audit departments spending substantial amounts of their time consummating a merger were properly capitalized). In contrast, pre-existing liabilities of the target corporation are not required to be capitalized by the purchaser. See, Rev. Rul. 73-146, 1973-1 C.B. 61 (Payments made by the surviving corporation pursuant to obligations arising previously under the acquired corporation's management incentive plan were not capitalized); Therefore, liabilities will be capitalized by the acquiring corporation, if the origin of these liabilities grows directly from the plan of reorganization. See, Rev. Rul. 76-520, 1976-2 C.B. 42.

ANALYSIS

The $[redacted] of employee bonuses were not liabilities of the corporation prior to the Agreement and Plan of Merger entered into by the parties in [redacted] Rather these liabilities arose pursuant to the principal stockholder's decision to exercise his bargained for rights under Article 6.12 of the Agreement and Plan of Merger. This sale of [redacted] was the origin of these liabilities, as opposed to any pre-existing employment or severance contracts. See, Great Lakes Pipe Line Co. v. United States, 352 F. Supp. 1159 (W. D. Mo. 1973), aff'd in an unpublished order, (7th Cir. 1974); see also, P.L.R. 9721002. In similar fashion to the internal merger and acquisition activities described in Rev. Rul. 73-580, the principal shareholder paid these amounts to reward certain key employees for their extra services rendered in connection with the merger. Therefore, the [redacted], as purchaser of [redacted], would be the proper party to capitalize these bonuses as a component of their purchase price.

It would be improper to re-construe these bonus payments as contributions of capital by the sellers. This proposed re-characterization presumes the substance of this transaction involves the [redacted] receiving the full purchase price, and then using a portion of the proceeds to make a contribution of capital to [redacted] The form of a transaction will only be ignored if its sole purpose is to obtain tax benefits, and it is otherwise devoid of economic substance. See, Levy v. Commissioner, 91 T.C. 838 (1988); Rice's Toyota World, Inc. v. Commissioner, 81 T.C. 184 (1983), aff'd. in part 752 F.2d 89 (4th Cir. 1985); Estate of Thomas v. Commissioner, 84 T.C. 412 (1985). Otherwise, business transactions will not be found to be without substance merely because they provide a tax benefit to a particular party. See, Frank Lyon Co. v. United States, 435 U.S. 561 (1978). The [redacted]'s assumption of these liabilities arising out of the merger justifies their capitalization of the $[redacted] as they bore the economic burden of paying these bonuses. As such, it would be inappropriate for the Service to ignore the form of this transaction, as the form reflects the economic substance of the deal.

This issue has been coordinated with our National Office, and George Johnson of CC:Corp:Br. 6 is in concurrence. If you have any questions regarding this matter, please contact the undersigned attorney at (313) 237-6433.

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By: ______________________
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Attorney